Nebraska Law Review

Volume 56 | Issue 2 Article 9

1977

Rule 10b-5: Scienter Displaces the Flexible Duty Standard: *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)

Larry V. Albers
University of Nebraska College of Law, larry@albersbrown.com

Note

Rule 10b-5: Scienter Displaces The Flexible Duty Standard

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

I. INTRODUCTION

Judicial creation of a private cause of action[1] under rule 10b-5,[2] which was promulgated pursuant to section 10(b)[3] of the Securities Exchange Act of 1934,[4] gave rise to a number of perplexing issues. One of the most formidable was whether proof of scienter was a necessary element for recovery. Lacking congressional direction,[5] courts were free to fashion the state of mind

---

1. A private cause of action under rule 10b-5, the administrative counterpart to section 10(b), arose five years after its adoption in Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa.), *additional findings of fact*, 83 F. Supp. 613 (E.D. Pa. 1947).
2. The text of rule 10b-5 is as follows:

   > It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   > (a) To employ any device, scheme, or artifice to defraud,
   > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
   > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

   17 C.F.R. § 240.10b-5 (1976).
3.
   > It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
   > . . . .
   > (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

   15 U.S.C. § 78j (1970) [hereinafter referred to as section 10(b) in text].
4. 15 U.S.C. § 78a-78hh (1970).
5. *See* note 29 *infra*.

standard flexibly, by pursuing what is recognized as the broad policy of section 10(b)—the prevention of fraud on the public by persons connected with the purchase or sale of securities. Predictably, the standards adopted within the United States courts of appeals[6] varied, depending upon such considerations as the type of relationship between the parties, the forseeability of injury to the plaintiff by the defendant, the ease with which such injury could have been avoided, the degree of culpability attending the defendant's act, and most important, the court's perception of congressional intent behind the language of section 10(b). The Supreme Court's recent decision in *Ernst & Ernst v. Hochfelder*[7] resolved the conflict by mandating that scienter be proved prior to any recovery for a private right of action under section 10(b).

Although the Court's decision in *Hochfelder* brought some welcome structure to an otherwise amorphous state of law, some questions regarding the scope of the decision deserve further attention. This note will examine the development of the law with respect to the state of mind element[8] in rule 10b-5 cases prior to *Hochfelder*, and will present some observations concerning the possible impact of this recent case.

II. FACTS

In *Hochfelder*, defendant Ernst & Ernst had been retained by First Securities Company of Chicago, a small brokerage firm, to perform periodic audits of the firm's books and records from 1946 to 1967. In addition, annual reports were prepared pursuant to the requirements of section 17(a)[9] of the Securities Exchange Act

---

6. *See* note 36 *infra.*
7. 425 U.S. 185 (1976).
8. For the purposes of this article, the "state of mind element" generically refers to those standards commentators have ascribed to the duty of care exercised and the state of knowledge possessed by an individual.
9. Pertinent parts of the provision read:

> Every . . . broker or dealer who transacts a business in securities through the medium of any such member [of a national securities exchange] . . . shall make, and keep for prescribed periods such records, furnish such copies thereof, and make and disseminate such reports as the Commission by rule prescribes as necessary or appropriate in the public interest or for the protection of investors . . . .

15 U.S.C. § 78q(a) (1970).

> The report of a member, broker or dealer shall be certified by a certified public accountant or a public accountant who shall be in fact independent.

17 C.F.R. § 240.17a-5(b)(d) (1976).

> The audit shall be made in accordance with generally accepted auditing standards and shall include a review of the

of 1934. During this twenty-one year period, Lester Nay, president and major stockholder of the firm, had induced plaintiffs to make investments in escrow accounts. Nay instructed customers to make checks payable to himself or to a designated bank account, and converted the funds to his personal use, omitting to make any entries in First Securities' books. The fraud was uncovered in 1968 when Nay committed suicide, leaving a note describing the escrow accounts as "spurious." Plaintiffs subsequently filed suit against Ernst & Ernst for damages, basing their secondary liability claim on the theory that Ernst & Ernst had "aided and abetted" Nay's violations by negligently failing to utilize appropriate auditing procedures to uncover internal practices concealing the fraud. Specifically, Nay had adopted a "mail rule," whereby no one was permitted to open mail addressed to him at First Securities, even while he was on extended vacations. Plaintiffs contended that had this "mail rule" been disclosed in its annual report to the Securities and Exchange Commission, an investigation of Nay by the Commission would have uncovered the fraudulent scheme involving the escrow account much earlier, preventing extensive investment losses.

III. THE STATE OF MIND ELEMENT BEFORE *HOCHFELDER*

A. Common Law

A rule 10b-5 action has as its progenitor the common law action of deceit. Although the deceit action is of early origin,[10] it was not until 1789[11] that an English court determined it to be purely a tort action which would lie regardless of any contractual relationship between the parties.

As the divergence between deceit actions in tort and in contract broadened, the different elements required for each action also became apparent. *Derry v. Peek*[12] is the leading case of tortious misrepresentation, requiring proof by the plaintiff that defendant *knew* the falsity of his statement, a showing of mere negligence being insufficient. The facts and holding of *Derry*, which involved

---

accounting system, the internal accounting control and procedures for safeguarding securities.

[1976] 3 FED. SEC. L. REP. (CCH) ¶ 33,924.

10. As early as 1201, there existed in England a writ of deceit which would lie against a person misusing legal procedure for the purpose of swindling someone. *See* W. PROSSER, LAW OF TORTS 685 (4th ed. 1971).
11. Palsey v. Freeman, 100 Eng. Rep. 450 (K.B. 1789). This case is commonly referred to as the parent of the modern deceit action.
12. [1889] 14 A.C. 337.

misrepresentation in the issuance of stock, contribute to an understanding of security fraud cases under common law. In *Derry,* directors of a tramway company issued a prospectus containing a statement that the company had received authorization to use steam or mechanical power for the propulsion of its tramway. Plaintiff, allegedly relying on this statement, purchased shares of stock in the company. Subsequent to his purchase, the directors learned that further government authorization was necessary for the company to operate the tramway mechanically. Application for such authorization was denied and the company became insolvent. In denying recovery based upon a negligence theory, Lord Herschell stated:

> First, in order to sustain an action of deceit there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made 1) knowingly, or 2) without belief in its truth, or 3) recklessly, careless whether it be true or false. . . . Thirdly, if fraud be proved, the motive of the person guilty of it is immaterial.[13]

The three states of mind traditionally viewed as elements of scienter are (1) knowledge of the false representation, (2) lack of a belief in its truth, or (3) reckless disregard for its truth.[14] *Derry* drew the line between scienter and negligence, holding that scienter would not be found if defendants had a good faith belief in the truth of their representation. However, as Professor Prosser noted, "the very unreasonableness of such a belief may be strong evidence that it does not in fact exist."[15]

Later courts[16] justified disallowance of recovery in deceit cases when mere negligence was alleged on the notion that an invasion of a pecuniary interest was not worthy of the same treatment as negligent injury to the person or property of another.[17] That

13. *Id.* at 374.
14. Professor Prosser's analysis of cases applying scienter concludes that:

> There is of course no difficulty in finding the required intent to mislead where it appears that the speaker believes his statement to be false. Likewise there is general agreement that it is present when the representation is made without any belief as to its truth, or with reckless disregard whether it be true or false. Further than this, it appears that all courts have extended it to include representations made by one who is conscious that he has no sufficient basis of information to justify them.

W. PROSSER, *supra* note 10, at 701.

15. *Id.*
16. *See* Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164 (C.A. 1950).
17. It was not until 1964, in Hedley Bryne & Co. v. Heller & Partners, [1964] A.C. 465 (1963), that the House of Lords overruled past case law, extending liability for negligence to pecuniary loss in any case where some "special relation" between the parties could be found.

notion, coupled with the impetus of the *Derry* decision, prevailed in the American courts until 1927, when in *International Products Co. v. Erie R. Co.*,[18] the New York Court of Appeals permitted recovery for "negligent misrepresentation." Judge Andrews, delivering the opinion of the court, wrote:

> Liability in such cases arises only where there is a duty, if one speaks at all, to give the correct information. . . . There must be knowledge, or its equivalent, that the information is desired for a serious purpose . . . . Finally, the relationship of the parties, arising out of contract or otherwise, must be such that in morals and good conscience the one has the right to rely upon the other for information . . . .
>
> . . . .
>
> We have an inquiry such as might be expected in the usual course of business made of one who alone knew the truth. We have a negligent answer, untrue in fact, actual reliance upon it, and resulting proximate loss.[19]

International Products initiated a new line of decisions[20] which shifted the emphasis for determining liability from defendant's state of mind to the type of relationship[21] existing between the parties when the misrepresentation was made. In *International Products*, a bailor-bailee relationship was sufficient to impose liability for negligent misrepresentation.

---

18. 244 N.Y. 331, 155 N.E. 662, *cert. denied*, 275 U.S. 527 (1927).
19. *Id.* at 338-39, 155 N.E. at 664.
20. *See, e.g.*, United States v. Garcia & Diaz, Inc., 291 F.2d 242 (2d Cir. 1961) (defendant's act in incorrectly weighing government freight shipment need not have been intentional for liability under misrepresentation); Park National Bank v. Globe Indemnity Co., 332 Mo. 1089, 61 S.W.2d 733 (1933) (notary public liable for negligently certifying a false certificate); Doyle v. Chatman & Phenix Nat. Bank of New York, 253 N.Y. 369, 171 N.E. 574 (1930) (good faith purchaser permitted recovery for trustee's negligent representation in certifying corporate bonds).
21. In deceit cases where scienter must be proved and is then found lacking, courts can generally dispose of the issue without resort to discussion of whether a duty was owed the plaintiff by defendant. Once intent is shown, most American courts facing the issue have followed Peek v. Gurney, [1873] L.R. 6 E. & I. App. 377, limiting liability to those whom defendant desired to influence. See W. PROSSER, *supra* note 10, at 702. In some cases, courts have been willing to extend liability to situations where defendant had a definite reason to anticipate plaintiff's reliance. *See, e.g.*, New York Title & Mortgage Co. v. Hutton, 71 F.2d 989 (D.C. Cir.), *cert. denied*, 293 U.S. 605 (1934) (defendant could not "as an ordinarily prudent man anticipate" that its letter would be used to solicit stock purchases); National Shawmut Bank of Boston v. Johnson, 317 Mass. 485, 58 N.E.2d 849 (1949) (forged signatures went with the notes, entitling the holder in due course to maintain an action in deceit).

One consideration deemed significant in determining which relationships give rise to liability is the forseeability of a plaintiff's reliance. However, most courts considering this issue have been reluctant to extend liability to all situations where plaintiff's reliance on the statement was forseeable.[22] This reluctance may be due to the fact that injuries to pecuniary interests through misrepresentation potentially can involve more plaintiffs and higher monetary damages than tort cases involving personal injury or property damage. Explanation of the difference lies in the nature of the tort. Whereas property and personal injury suits generally are confined to the immediate participants, vicinity, and time of the tortious act, injury caused by a misrepresentation is often widely disseminated to the public via mass communication. The scope of liability is especially broad in security cases, particularly when an accountant's auditing reports will be relied upon by a large number of creditors, stockholders, banks, and persons contemplating purchase of securities.[23] Consequently, courts accepting negligent misrepresentation as a basis of liability generally draw the line as follows:

> When the representation is made directly to the plaintiff, in the course of dealings with the defendant, or is exhibited to him by the defendant with knowledge that he intends to rely upon it, or even where he is an unidentified member of a group or class all of whom defendant is seeking to influence, there has been no difficulty in finding a duty of reasonable care; and the same duty has been found where it is made to a third person with knowledge that he intends to communicate it to the specific individual plaintiff for the purpose of inducing him to act.
>
> [M]ere reasonable anticipation that the statement will be communicated to others whose identity is unknown to the defendant, or even knowledge that the recipient intends to make some commercial use of it in dealing with unspecified third parties, is not sufficient to create a duty of care toward them.[24]

Distinctions between liability for economic and property or personal injury have whithered with the passage of time and chang-

22. W. PROSSER, *supra* note 10, at 702.
23. For an excellent discussion of the developing securities law with respect to accountant's liability, see Fiflis, *Current Problems of Accountant's Responsibilities to Third Parties*, 28 VAND. L. REV. 31 (1975).
24. W. PROSSER, *supra* note 10, at 707-08. The most notable cases cited by commentators as representing the line of liability were written by Justice Cardozo while sitting on the New York Court of Appeals. In Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922), defendants had incorrectly certified the weight sheets of beans sold to the plaintiffs by a third party. Finding the plaintiffs liable for negligent misrepresentation, the court stated: "The plaintiffs use of the certificate was not an indirect or collateral consequence of the action of the weighers.

ing social attitudes to the extent that many courts would permit a common law recovery upon a showing of negligence. However, further expansion of the common law[25] associated with securities fraud largely has been pre-empted by blue sky laws and most significantly, federal securities laws.

B. Rule 10b-5 Private Rights of Action

Congress's response to the inimical practices employed in security markets, leading to the crash of 1929, was the Securities Act of 1933[26] and the Securities Exchange Act of 1934.[27] The two acts were passed following extensive hearings and committee debates considering the appropriate mechanisms and standards for ensuring adequate disclosure of material information to the investor. However, section 10(b)[28] of the 1934 Act was passed by both the House and Senate with little of the controversy and debate surrounding other provisions of the Act.[29] The salient features of the provision are as follows.

> It shall be unlawful . . . .
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . .

Mindful that no private right of action explicitly was provided for in section 10(b), House and Senate leaders apparently were oblivious to the potential of section 10(b) as a major vehicle for fraud

---

It was a consequence which, to the weigher's knowledge, was the end and aim of the transaction." *Id.* at 238-39, 135 N.E. at 275. The potential scope of this language instilled sufficient anxiety in the business community to compel Justice Cardozo to more clearly define its limits years later in Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931). The defendants, a reputable accounting firm, had certified a balance sheet of Fred Stern & Co. as representing accurately its financial condition, when in fact, the books had been falsified by those in charge of the business. Upon distinguishing the facts of *Glanzer*, the court in *Ultramares* found no duty was owed to the plaintiffs to certify the financial sheets free from negligence, their reliance being incidental and collateral to the service rendered primarily for the benefit of Fred Stern & Co.

25. Besides the state of mind standard, plaintiffs suing under common law must contend with elements of "the relationship of the parties," "justifiable reliance," and "resultant damage stemming from defendant's statement." *See* W. PROSSER, *supra* note 10, at 685-86.
26. 15 U.S.C. § 77a-77bbbb (1970).
27. *See* note 4 *supra*.
28. 15 U.S.C. § 78j(b) (1970).
29. Of nearly a thousand pages of hearings in the House, the combined

recovery.[30] Consequently, scant material exists from which to draw expressions of congressional intent regarding the state of mind a defendant must possess for a plaintiff to maintain an action under section 10(b).

Rule 10b-5,[31] like its statutory parent, was adopted without controversy in 1942. The Securities and Exchange Commission promulgated the rule in response to an alleged case where a corporate insider fraudulently was able to purchase its firm's securities with impunity from existing Commission enforcement powers.[32] Because the only provision which dealt with purchases of securities was section 10(b), the Commission staff drafted rule 10b-5,[33] drawing much of its language from section 17(a) of the 1933 Act.[34]

Nearly 14 years after the passage of the Securities Act of 1934, a private right of action under rule 10b-5 was first recognized in *Kardon v. National Gypsum Co.*[35] As other courts followed the *Kardon* lead, differences arose between the federal circuits[36] over whether a rule 10b-5 action could be maintained absent a showing of scienter, and if so, under what circumstances. This confusion can be attributed primarily to three sources. First, the scant

references to § 10(b) (then 9(c)) would scarcely fill a page. Much the same is true in the Senate. 1 A. BROMBERG, SECURITIES LAW FRAUD: SEC RULE 10b-5, 22.3 (1975). The committee reports paraphrase the language of the several Bills, providing little direction concerning the state of mind standard. *See* S. REP. No. 792, 73d Cong., 2d Sess. 18 (1934); H.R. REP. No. 1838, 73d Cong., 2d Sess. 32 (1934).

30. At the same time, there is no indication that Congress thought it was creating private rights in § 10(b). *See* A. BROMBERG, *supra* note 29, at 22.4. *See also* Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U.L. REV. 627, 642-60 (1963).
31. *See* note 2 *supra.*
32. The now well-known address of Milton Freeman, the former employee of the Securities and Exchange Commission responsible for drafting rule 10b-5, is revealing of the Commission's failure at that time to appreciate the rule's future impact. *See* Freeman, *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967). *See also* SEC Securities Act Release No. 3230 (May 21, 1945).
33. *See* note 2 *supra.*
34. 15 U.S.C. § 77q(a) (1970).
35. 73 F. Supp. 798 (E.D. Pa.), *additional findings of fact*, 83 F. Supp. 613 (E.D. Pa. 1947).
36. Cases holding that negligence alone is sufficient for liability under rule 10b-5 include White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Myzel v. Fields, 386 F.2d 718 (8th Cir.), *cert. denied*, 390 U.S. 951 (1967); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963). Two courts of appeals have held that some type of scienter is required. *See, e.g.*, Clegg v. Clonk, 507 F.2d 1351 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975); Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

legislative history on section 10(b) does not contemplate a private cause of action.[37] Accordingly, Congress did not consider whether scienter should be an element of such an action. Second, many courts have indicated that application of a single standard would produce intolerable results. Consequently, the broad language of Rule 10b-5 has permitted courts to find liability for fraud in a variety of factual situations. This flexible approach accounts for the significance of a particular element in each case, depending upon such inquiries as defendant's culpability in bringing about the injury, the foreseeability of reliance by the plaintiff, or the extent to which the defendant should be required to compensate the defendant for his loss. Finally, courts and commentators[38] are at odds on how to resolve semantical problems arising through use of different sets of standards for what are conceptually identical results. For instance, Professor Bromberg prefers separating the historical standards used in deceit and misrepresentation cases into three distinguishing classifications: (1) knowledge, (2) state of mind, and (3) care criteria.[39] "Knowledge" criteria are purportedly the most appropriate to use in section 10(b) cases because no moral connotation attaches to these standards as was historically the case with "state of mind" and "care" criteria. However, the Court in *Hochfelder*, like other courts previously, made reference throughout the opinion to "negligence," a criterion Professor Bromberg reserves for standards dealing with care.[40]

A review of the major cases in the various federal circuit courts of appeals reveals two general approaches used to dispose of the state of mind issue in rule 10b-5 cases: (1) the "flexible duty standard" and (2) the requirement of scienter. A short discussion of these approaches follows, focusing on two cases representative of their respective lines of authority.

The "flexible duty standard" was coined after commentators[41] recognized that one group of decisions articulated different stand-

---

37. *See* note 30 *supra*.
38. *See, e.g.*, Green, *The Communicative Torts*, 54 TEX. L. REV. 1 (1975). Professor Green contends that the two areas of tort law are based on a duty of care and the duty to inform. The failure of courts to recognize this distinction is said to have resulted in added confusion in applying the requisite standard.
39. A. BROMBERG, *supra* note 29, at 204.101-.105.
40. *Id.* at 204.104.
41. *See* Comment, *Development of a Flexible Duty Standard of Liability Under SEC Rule 10b-5*, 32 WASH. & LEE L. REV. 99 (1975); *Scienter and Rule 10b-5: Development of a New Standard*, 23 CLEV. ST. L. REV. 493 (1974).

ards, depending upon the facts of each case. *White v. Abrams*[42] was the first important case to list those factors to be considered when determining the requisite state of mind standards to be applied.

> Although it would be inappropriate for us to attempt to set forth all of these factors, past 10b-5 cases have established many of them. Without limiting the trial court from making additions or adaptations in a particular case, we feel the court should, in instructing on a defendant's duty under rule 10b-5, require the jury to consider the relationship of the defendant to the plaintiff, the defendant's access to the information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether the plaintiff was relying upon their relationship in making his investment decisions and the defendant's activity in initiating the securities transaction in question.[43]

Although courts that followed the flexible duty approach found negligence alone to be a sufficient basis for liability, some circuits continued to require some type of scienter for civil liability under rule 10b-5. Exemplary is the Second Circuit's decision in *Lanza v. Drexel Co.*.[44] There the court relied upon the words of section 10(b) in maintaining that more than negligence was required. This position later was adopted by the Supreme Court in *Hochfelder.*

> Yet the rule-making power granted to the Securities and Exchange Commission by Section 10(b) authorizes rules making it unlawful "to use or employ . . . any *manipulative* or *deceptive* device or contrivance . . . (emphasis added). These words negate liability for a mere negligent omission or misrepresentation.[45]

With the conflicting lines of authority between the Circuits causing considerable concern and confusion, the Supreme Court's intervention in *Hochfelder* was expected.

IV. *HOCHFELDER*

On appeal from the district court's decision granting defendant's motion for summary judgment, the Seventh Circuit pursued its own flexible duty approach, holding that defendants would be found liable as aider-abettors for a rule 10b-5 violation upon a showing that their conduct fulfilled five criteria.[46] Unlike the

---

42. 495 F.2d 724 (9th Cir. 1974).
43. *Id.* at 735.
44. 479 F.2d 1277 (2d Cir. 1973).
45. *Id.* at 1305.
46. Accordingly, where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, a claim for aiding and abetting is made on demonstrating: (1) that the defendant had a duty of inquiry; (2) the plaintiff was a beneficiary of that duty of inquiry; (3) the defendant breached the duty of inquiry; (4) concomitant

factors the court in *White* determined to be of significance, the Seventh Circuit looked solely at section 17(a)[47] of the 1934 Act and Rule 17a-5[48] to find the duty of Ernst & Ernst to exercise reasonable care in conducting the audit according to generally accepted auditing standards, including investigation into First Securities' internal accounting controls. The case was remanded by the court to consider whether Ernst & Ernst was negligent in failing to uncover Nay's mail rule, and if so, whether there was a causal connection between the breach of duty of inquiry and facilitation of the underlying fraud.

One of the issues before the Seventh Circuit was whether Ernst & Ernst was liable under common law for negligent misrepresentation. After recital of the outer limits of such liability, the court dismissed the claim, holding that "at no time did Ernst & Ernst specifically foresee that plaintiffs' limited class might suffer from the consequences of a negligent audit on its part."[49] Unaware of Nay's solicitations concerning the "escrow accounts," Ernst & Ernst could not envision plaintiffs as a class to which it owed a duty of inquiry.

The narrow issue presented on appeal to the Supreme Court was whether scienter is a necessary element of an "aiding and abetting"[50] violation of rule 10b-5. Nevertheless, the Court framed the issue[51] to cover all private causes of action for damages under section 10(b), thereby expanding the reach of the decision beyond the immediate facts. This result was the necessary outgrowth of the Court's desire to find one standard applicable in all section 10(b) cases.

The decision hinged, as have past decisions considering the issue, on how the Court interprets Congress's intent in proposing

---

> with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud.

503 F.2d at 1104.

47. *See* note 9 *supra.*
48. *See* note 9 *supra.*
49. 503 F.2d at 1107.
50. The concept is borrowed from criminal law. *See* 18 U.S.C. § 2(a) (1970). There appears to be some dispute whether aiding and abetting is a separate tort under securities law. *See* A. BROMBERG, *supra* note 29, at 204.175.
51. "We granted certiorari to resolve the question whether a private cause of action for damages will lie under § 10(b) and Rule 10b-5 in the absence of any allegation of "scienter"—intent to deceive, manipulate, or defraud." 425 U.S. at 193.

and passing section 10(b). Recognizing that an examination of committee hearing transcripts and reports is generally unrevealing, Justice Powell, writing the opinion, looked to what he considered to be the common understanding of the essential words in section 10(b).

> Section 10(b) makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. The words "manipulate or deceptive" used in conjunction with "device or contrivance" strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct.[52]

Additionally, the Court considered section 10(b) in relation to those provisions of both Acts providing explicit civil remedies. The Court found it significant that where Congress allowed recovery for negligent conduct, procedural restrictions also were attached.

> Section 11(e) of the 1933 Act, for example, authorizes the court to require a plaintiff bringing a suit under § 11, § 12(2), or § 15 thereof to post a bond for costs, including attorney's fees and in specified circumstances to assess costs at the conclusion of the litigation. Section 13 specifies a statute of limitations of one year from the time the violation was or should have been discovered, in no event to exceed three years from the time of offer or sale, applicable to actions brought under § 11, § 12(2), or § 15 . . . . Such extension [to actions premised on negligent wrongdoing] would allow causes of action covered by § 11, § 12(2), or § 15 to be brought instead under § 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express actions.[53]

V. ANALYSIS

Prevention of securities fraud on the public through rigorous enforcement of the securities laws promotes three policies: (1) restoration of investor confidence in the corporate capacity to deal fairly with its security holders, (2) disclosure of material information upon which the investor can make an intelligent decision, and (3) strengthening of the American economy as a whole through elimination of many practices which contributed to the stock market crash of 1929. Although these policies are commendable, the absence of comprehensive and clear standards[54] in the 1933 and 1934 Acts establishing the bounds of fraud liability has left courts the dilemma of choosing between two important principles. On

52. *Id.* at 197.
53. *Id.* at 209-10.
54. *See* 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW 1-3, 1-13 (1975).

the one hand, courts have the responsibility to provide relief on an ad hoc basis from fraudulent practices novel in their approach and beyond the explicit reach of any statutory design. If congressional policies embodied in the acts are to be furthered, courts cannot look solely to the language of those fraud provisions dealing with particular transactions and parties. In this respect, the broad language of section 10(b) and rule 10b-5 affords an appropriate vehicle for courts attempting to fashion a more comprehensive scheme of fraud liability. Simultaneously, it must be recognized that if those affected by these statutes are expected to pattern their behavior so as to avoid liability for tremendous damages, the legal criteria for determining liability must provide a reasonable indication of the proscribed activities.[55] The Court's determination to adhere closely to the language of section 10(b), while raising some issues addressed below, merits recognition as a step toward placing the burden on Congress to provide more explicit guidelines with respect to establishing rule 10b-5 private rights of action and fraud liability in general.

The Court's decision in *Hochfelder* perhaps can be understood better after consideration of the difficulties inherent in the Seventh Circuit's approach reaching the opposite result.

Because Ernst & Ernst was not a party to the immediate transactions involving the escrow accounts, the Seventh Circuit had to inject a secondary theory of liability if plaintiffs were to recover for their loss. The court found that the duty which Ernst & Ernst owed to the plaintiffs arose from section 17(a), requiring an audit and filing of statements in accordance with generally accepted auditing standards. But rather than create a new cause of action under 17(a), section 10(b), supplemented with an aiding and abetting theory, constituted the vehicle for finding liability. One conceptual difficulty with this approach rests in the court's loose application of the aiding and abetting theory. Contrasted with the weight of authority articulated previously by the Seventh Circuit and by other circuits[56] all of which require some awareness by the

55. The American Law Institute has drafted a comprehensive legislative scheme governing federal regulation of securities. Included is a section devoted to fraudulent and manipulative acts. *See* A.L.I. FEDERAL SECURITIES CODE (Reptrs. Rev. Tent. Draft Nos. 1-3, 1974).

56. *See* Woodward v. Metro Bank of Dallas, 522 F.2d 84 (5th Cir. 1975) (an alleged aider-abettor should be found liable only if scienter of the high "conscious intent variety" can be proved); Securities Exchange Commission v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975) (accused party must have general awareness that his role was part of an overall activity that is improper); Landy v. Federal Deposit Ins. Corp., 486 F.2d 139 (3d Cir. 1973), *cert. denied*,

aider-abettor of his assistance in the fraud, the Seventh Circuit was content to substitute an alleged negligent breach of a section 17(a) duty even though defendants had no knowledge of the escrow accounts. Additionally, if the court determined that Ernst & Ernst breached a duty of inquiry established by section 17(a), creation of a new section 17(a) cause of action would have avoided the need to distort the aiding and abetting theory and further entangle the web of section 10(b) and rule 10b-5.

The logic of the Seventh Circuit's approach is further weakened by a consideration of the relation of section 17 to section 18 of the 1934 Act. Section 18[57] creates a private right of action against certain persons, including accountants, who "make or cause to be made" materially misleading statements in reports or other documents filed with the Securities and Exchange Commission. Since the reports omitting mention of the "mail rule" were filed with the Commission by Ernst & Ernst pursuant to section 17(a), section 18 would have provided an appropriate remedy. Liability extends to persons who, in reliance on such statements, purchased or sold a security whose price was affected by such statements. Liability will not lie if the person being sued proves he acted in good faith and without knowledge that the statement was false. Although there is no indication that section 18 was intended to be the sole authority for providing recovery from misleading statements filed pursuant to the requirements of the 1934 Act, its remedy rarely would be used if plaintiffs need only satisfy the lesser standards established by the Seventh Circuit. Consequently, the inherent consistency manifested in the 1934 Act was sacrificed in the court's determination to find Ernst & Ernst liable.

The Court's decision in *Hochfelder* rectified the potentially bothersome approach pursued in the Seventh Circuit by requiring adherence to a stricter interpretation of section 10(b) to find rule 10b-5 liability. However, in holding scienter to be a necessary

416 U.S. 960 (1974) (knowledge of the wrong's existence required); Securities and Exchange Commission v. First Securities Co. of Chicago, 463 F.2d 981 (7th Cir.), *cert. denied*, 409 U.S. 880 (1972) (First Securities had knowledge of Nay's "mail rule" and permitted its use); Brennan v. Midwestern United Life Insurance Co., 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970) (the president and chief counsel of the corporation were "aware of the defrauder's scheme" to use client's money as working capital).

57. (a) Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not

element for all private actions under section 10(b), the decision itself poses three problems concerning its possible scope.

First, courts may be faced with the issue of whether the Securities and Exchange Commission now must prove scienter when bringing an enforcement action for compliance with regulations promulgated under section 10(b). If the Court's decision hinged on its construction of the words "manipulate, device, and contrivance" in section 10(b) as evidence of Congressional intent to proscribe only fraudulent conduct where scienter was present, then presumably, the same meaning attaches to all section 10(b) actions. Prior to *Hochfelder*,[58] therd was little doubt that a rule 10b-5 action for injunctive relief could be brought by the Securities and Exchange Commission upon a showing of negligence. Justification for a lesser standard can be supported primarily on the notion that where prohibition of identifiable future conduct is involved, little need exists for showing whether defendants had actual knowledge of their alleged illicit practices in the past or not. The past state of defendant's mind is irrelevant. The argument is persuasive and should continue to be the basis for not requiring proof of scienter in Securities and Exchange Commission enforcement actions.

Second, stockholders may be afforded inconsistent means of relief depending upon whether the fraud was committed in the sale or in the purchase of securities. As evinced by the previous discussion of rule 10b-5, its promulgation was a response to a situation where a person, usually a corporate insider, committed fraud during his *purchase* of securities. After *Hochfelder*, it is possible that a corporation will be compelled to pay damages for negligence committed in the sale of its securities, but not for negligence in any purchases. For instance, a negligent failure by a corporate employee to make a notation in the records regarding a $500,000 tax refund would be insufficient grounds for the seller of securities to the corporation, relying on those records, to recover under rule 10b-5.[59] Scienter must be proved. However, negligent omission of a notation in the prospectus of a $500,000 tax liability

knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

15 U.S.C. § 78r (1970).

58. *See, e.g.*, Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir.), *cert. denied*, 394 U.S. 176 (1968).

59. *See* Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967).

may give rise to corporate liability under section 12(2)[60] of the 1933 Act. Any attempt to rationalize treating these examples differently is specious. Thus, having fixed a rigid standard of scienter for every rule 10b-5 action, the Court's decision removed the flexibility needed to apply the securities laws consistently and rationally.

A third issue involves the Court's definition of scienter. In a footnote, Justice Powell stated:

> In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10 and Rule 10b-5.[61]

Arguably, the Court's reluctance to decide one way or the other rests upon a desire to avoid binding itself to a conclusion of law until actually presented with the issue. Additionally, commentators differ on whether standards of negligence and recklessness are even appropriate for misrepresentation cases, which technically involve a duty to inform rather than a duty of care. Nevertheless, whatever conceptual difficulty abounds in attempting to apply duty of care to misrepresentation cases, the practical affect of applying one or the other may be of little significance to the factfinder. In other words, in most instances a finding of liability may result regardless of whether the standard is framed in terms of whether defendant "had knowledge of facts stimulating inquiry"[62] or "acted in conscious disregard of or indifference to the risk that recipients of information will be misled."[63] Finally, if scienter is to be a required element in all section 10(b) cases, clarification by the Court of what definitional standards the term embraces would have contributed to a better understanding by future courts faced with applying the requisite scienter standard. In all probability, how-

60. Any person who—

> . . .
>
> (2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact . . . who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing the security.

15 U.S.C. § 771 (1970).

61. 425 U.S. at 194, n.12.

62. 1 Merrill on Notice § 18 (1952) (definition of "constructive knowledge").

63. A. Bromberg, *supra* note 29, at 204.208, (definition of "recklessness").

ever, courts will look to the term's meaning at common law—a meaning which generally has included "recklessness."[64]

VI. CONCLUSION

Since its inception as a private right of action, section 10(b) has been the most powerful weapon in the plaintiff's arsenal of fraud provisions. Its reach, unimpeded by any congressional language evincing a desire to confine its application, had expanded inexorably to cover transactions and parties not covered by the more explicit prescriptions under the 1933 and 1934 Acts. The Court's decision in *Hochfelder*, requiring proof of scienter in all private actions brought under rule 10b-5 undoubtedly will restrict the rule's coverage of fraud liability in the future by removing the flexibility some courts had exercised in attempting to fashion relief according to the broader policies underlying the 1933 and 1934 Acts.

However, by confining lower courts to a stricter interpretation of section 10(b)'s language, the Court has determined that if the legislative scheme is unclear in its intended scope, the responsibility for determining the outer bounds of fraud liability rests with Congress not the courts. In this respect, *Hochfelder* more accurately reflects what most other courts considering the issue had previously declared—it is simply fulfilling congressional intent.

Larry V. Albers '77

---

64. *See* note 14 *supra*.